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INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUCPDOC/DEPT OF COMMERCE WASHDC
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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-ABAUKOL
SINGAPORE FOR BAKER
COMMERCE FOR 4430/BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A
TAGS: EFIN EINV ECON PGOV ID
SUBJECT: BANKING SECTOR UPDATE 2007 - NEW REGULATION ON
CONSOLIDATION

A) Jakarta 13420

¶1. (U) Summary. Since announcing its 2005 Indonesian Banking Architecture plan, Bank Indonesia has launched several policy packages and regulations to promote banking consolidation via merger. On September 21, Bank Indonesia issued a new regulation setting out additional incentives for bank consolidation. The incentives include lower minimum reserve requirements, easier rules for banks to upgrade their status to foreign exchange banks, relaxed requirements concerning corporate governance, and streamlined procedures for submitting a merger plan. End Summary.

Background on Bank Consolidation

¶2. (U) In June 2005, the Bank Indonesia (BI) launched a banking consolidation policy in an effort to prepare the banking sector for the planned implementation of the Basel II Capital Accord in 2008. Under the 2005 policy, banks were required to have at least Rp 80 billion (US $8.5 million) in Tier 1 capital by the end of 2007 and at least Rp 100 billion in Tier 1 capital by the end of 2010.

¶3. (U) In October 2006, BI launched an additional banking policy package that included incentives to promote bank consolidation and a single presence rule (Ref A). Indonesia currently has 131 banks (not including very small rural banks which operate under a different classification and set of regulations). Of these 131, the top 10 comprise nearly 60% of the assets in the sector, leaving many small banks which contribute little to economic activity but create a large supervisory burden for BI. The 2006 regulations provided a host of incentives for banks to merge, including looser lending limits, lower minimum capital requirements, and relaxed rules for obtaining licenses to conduct foreign exchange operations.

Single Presence Policy

¶4. (U) Under the single presence rule in the October 2006 package, a single party is limited to controlling interest (25% or more) in only one banking organization in Indonesia. Some observers speculate that with this single presence policy, designed to encourage consolidation, BI also intended to force the privatization

of Indonesia's state-owned banks. BI had hoped for a large number of voluntary mergers before 2007, but to date, these policy changes have induced only a very limited number of small banks consolidations. BI expects banks to submit plans for compliance with the single presence policy by the end of 2007.

New Regulation: Incentives for Consolidation

¶5. (U) On September 21, 2007 BI issued a new regulation on Incentives for Bank Consolidation, amending the 2006 regulation. The new rules offer additional incentives to merge, including the further relaxation of requirements for lenders to become foreign exchange banks. Of the 131 banks in Indonesia, only 40 have foreign exchange licenses. Under the new regulation, any bank formed by merger or consolidation, regardless of the number of participating banks, may apply to upgrade its status to foreign exchange bank. However, these banks would need to meet a minimum Tier 1 capital requirement of Rp 100 billion ($11 million) and have a bank composite rating of a least two (sound), and a management rating of at least three (fairly sound) within two years of approval for merger/consolidation. (Note: BI rates banks on a scale of 1-5. The ratings are defined as 1 (excellent), 2 (sound), 3 (fairly sound), 4 (poor) and 5 (weak). End note.)

¶6. (U) The consolidation incentives also include a reduction in minimum mandatory reserve requirement (i.e., the amount of funds commercial banks have to set aside as reserves at the central bank) for newly merged banks. The new rules allow a 1% reduction in a merged bank's minimum reserve requirement within one year after the merger approval. BI currently sets the minimum reserve requirement in a range between 5% and 13% of a bank's rupiah deposits, depending on the bank's loan-to-deposit ratio (LDR). Banks with the lowest

LDRs have the largest minimum reserve requirements. In addition to providing an incentive to merge, BI hopes the lower reserve requirement will encourage commercial banks to allocate more funds for investments in high-yielding assets such as bonds or to expand lending, potentially boosting economic growth in Indonesia. According to our BI contact, the banks have responded positively to the lower reserve requirements.

Relaxed Corporate Governance for New Mergers

¶7. (U) The new regulation also relaxes the corporate governance standards required for newly merged banks. The new rules give a six-month grace period for banks to comply with the BI regulation that independent commissioners make up at least 50% of the Board of Commissioners. Further, if a bank has only one independent commissioner, he/she may concurrently chair three committees-Audit Committee, Risk Monitoring Committee, and Remuneration and Nomination Committee for up to six months after BI approves the merger.

Streamlined Procedures for Consolidation

¶8. (U) The regulation also streamlines procedures for submitting a consolidation plan. First, BI has eliminated the deadline for submission of merger plans. Second, BI will require only one of the banks participating in a merger to submit a consolidation plan. However, the President Directors of all participating banks must sign the plan. Any bank having submitted a merger plan prior to the enactment of this new regulation may submit an addendum to the plan and qualify for the new incentives.

Comment

¶9. (SBU) BI's previous incentives for consolidation have failed to prompt merger activity because most bank managers in Indonesia do not perceive significant economic benefits from merging with their

peers. The business models at most large, well-run Indonesian banks differ radically from the strategies employed at most smaller merger candidates. As a result, the larger banks plan to grow organically rather acquiring smaller institutions which would necessitate significant retraining of staff and management. In addition, Indonesian labor law requires large severance packages for laid-off workers, significantly raising the costs associated with effective consolidation. Since the new regulations do not address these issues directly, analysts do not expect a significant number of banks to take advantage of the additional incentives. Some bank analysts also have questioned the prudence of the certain aspects of the new regulations. History has shown that bank mergers generate significant operational problems if experienced managers do not carefully implement them. Relaxing corporate governance requirements and requiring only a "fairly sound" management rating for foreign exchange bank licenses are likely to generate more problems down the road. End comment.

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